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> **The usual effect of the attempts of government to encourage consumption, is merely to prevent saving that is to promote unproductive consumption at the expense of reproductive, and diminish the national wealth by the very means which were intended to increase it. What a country wants to make it richer is never consumption, but production. Where there is the latter, we may be sure that there is no want of the former.**
>
> **John Stuart Mill, "Of the Influence of Consumption on Production,"** ***Essays on Some Unsettled Questions of Political Economy*****, 1829**

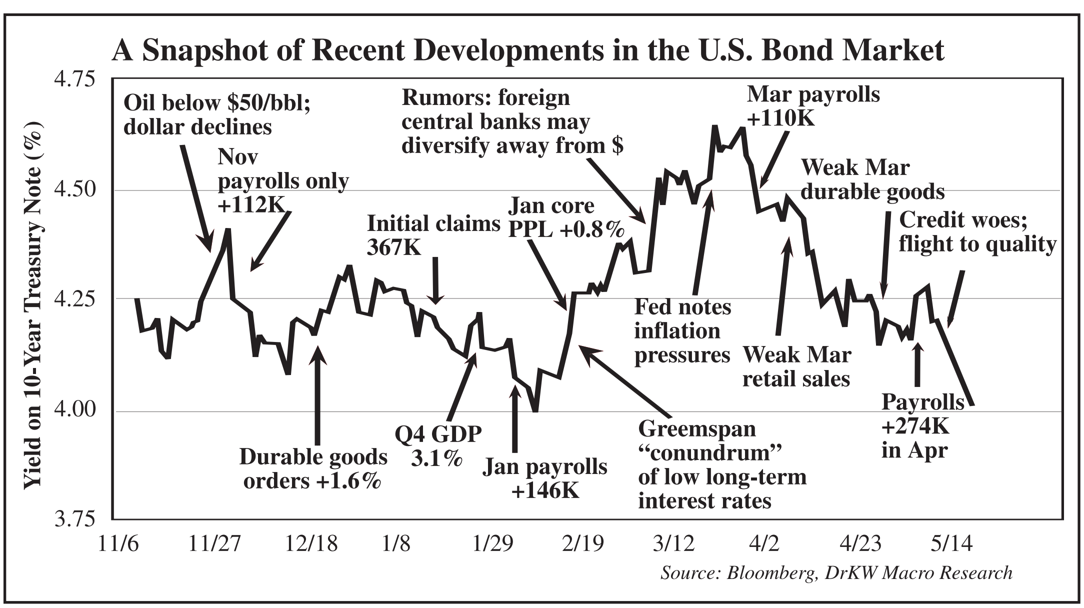
BUBBLE ANATOMY

Almost half of this year is already behind us. The biggest surprise, certainly, is the suddenly disappointing economic data about the U.S. economy. Whether this will be just another brief soft patch or a longer-lasting, rather serious, slowdown — if not worse — is the most important question for the whole world.

The just-published *World Economic Outlook* of the International Monetary Fund says this about the U.S. economy: *"With incoming data generally robust and business and consumer confidence strong, the outlook for 2005 is encouraging. GDP growth is projected to average 3.6%, somewhat higher than expected… with a moderation in private-consumption growth reflecting the gradual withdrawal of fiscal and monetary stimulus… offset by continued strength in investment. The risks to the forecast appear broadly balanced, with upside risks from the strength of corporate balance sheets, as well as rising housing and equity prices by the possibility of a more pronounced rebound in household savings."*

We have quoted this passage for two reasons: *first*, because the *World Economic Outlook* is a world authority in economics; and *second*, because its arguments are typical of the general complacency with which the U.S. economy's growth performance has been and continues to be judged in the face of unprecedented structural dislocations.

For the "soft-patch" crowd, some recent spots of weakness in the U.S. economy have their main culprit in the jump in energy prices and its temporary impact on inflation rates. Other optimistic arguments are contained inflation expectations and still-considerable slack in the product and labor markets. Last but not least, Fed officials stress the fact that monetary policy is still "accommodative" and, therefore, supportive to economic growth.



We must admit to

finding the singular focus on higher energy prices as the troublemaker in the U.S. economy more than simplistic. In our view, the world economy — and also the U.S. economy — is struggling with a lot of far bigger problems than higher oil prices. Besides, while these may have overshot, they could still stay high, and even rise further. They might even fall if the world economy, or large parts of it, turns significantly weaker.

We see the economic and financial development through a very different lens, and judging from the behavior of the financial markets, we have the impression that we are by no means alone in assuming more permanent and pronounced economic softness in the United States.

The recovery of the stock markets has stopped dead in its tracks. In June last year, the Dow closed the month at 10,300. Lately, it is hovering around 10,100. Investors of recent months are sitting on losses. Even more conspicuous for sudden changes of market sentiment about the U.S. economy's outlook seems to be the pronounced decline of the yield on the 10-year Treasury note over the last few months, from 4.6% toward 4%, and that in defiance of rising inflation rates and a trebling of the federal funds rate, from 1% to 3%.

While the U.S. economy has clearly slowed, the more relevant questions are, of course, the severity and duration of this slowdown. In the last letter, we described in some detail how the sudden stock market crash and the collapse of business fixed investment in 2000 took everybody, including the Federal Reserve, completely by surprise.

It goes without saying that it was not just by accident that we recalled this episode. We had our reason. At the time, the sky over the U.S. economy seemed cloudless. The stock market soared to new highs until March, and then, all of a sudden, the economy and the stock market slumped.

THE MILDEST RECESSION, BUT…

In hindsight, Federal Reserve Chairman Alan Greenspan and his consorts take pride in having managed the U.S. economy's mildest recession in the whole postwar period with their prompt policy responses, even though the stock market collapsed.

For sure, this was another incident that immensely enhanced Mr. Greenspan's reputation as the world's greatest central banker. Two years ago, he summed up the Fed view about this policy by declaring, *"Our strategy of addressing the bubble's consequences rather than the bubble itself has been successful."* (See his Jan. 3, 2003, speech "Risk and Uncertainty in Monetary Policy," delivered to the annual meeting of the American Economic Association in San Diego.)

We have never agreed with this complacent assessment. What remains manifestly missing in this scenario is the V-shaped recovery that has been typical of all postwar recoveries but that has grossly failed to materialize this time. The final judgment has to weigh the earlier gains from the milder recession against the comparative later losses in the growth of GDP, employment and income from the unusually weak recovery over the three years since 2001. For sure, the latter losses vastly outweigh the earlier, minor gains.

FROM BUBBLE TO BUBBLE

However, that is only one reason why we have always regarded the story of the "mildest recession" as a great delusion. But this raises a second crucial question: Why has the unusually aggressive combination of monetary and fiscal policy so lamentably failed to generate a recovery of the vigor that had been standard in postwar periods?

Our short answer: The Greenspan Fed deliberately pursued a policy to instantly replace the bursting equity bubble with another, even greater, housing bubble. By rapidly slashing interest rates to rock-bottom levels, it succeeded in generating the housing bubble and also in provoking the consumer to sustain and accelerate his borrowing-and-spending binge, now against the soaring collateral of rising house prices.

The consensus sees a tremendous success. In reality, it was by far the U.S. economy's weakest recovery in the whole postwar period, with grossly lacking employment and income growth. That is a decisive failure. Moreover, at the same time, the aggressive policies and the resulting unbalanced recovery vastly aggravated the

existing imbalances in the economy.

Recessions are intrinsically the phase in the business cycle in which businesses and consumers exert restraint by unwinding some of the borrowing-and-spending excesses of the prior boom. In the United States, the exact opposite happened this time.

While businesses restrained their spending and hiring, private households and the government stepped up their borrowing and spending. Economic growth recovered, but it should not be overlooked that this "success" had its flip side in an unprecedented escalation of economic and financial imbalances.

In 2000, national savings — the compound savings of the government, businesses and private households — amounted to $817.6 billion, or 8.3% of GDP. The profligate policies of the following years slashed them to $212.7 billion, or 1.8% of GDP, by 2004. The U.S. current account deficit in 2000 came to $413.4 billion and in 2004, to $665.9 billion. In 2000, the federal government ran a surplus of $295.9 billion. In 2004, it had a deficit of $362.6 billion. In 2000, private household debt equaled 97% of disposable income; in 2004, this ratio was up to 120%.

Could it be that these imbalances are damaging to economic growth and general prosperity? You bet they are. The greatest and most obvious damage derives from the escalating trade deficit in the U.S. manufacturing sector. The U.S. economy is being virtually deindustrialized. The sector has lost 3 million jobs since 2000 and keeps losing them month after month.

Yet American policymakers and most economists do not appear to be worrying about any damages to the economy. From their public talk, we must presume a complete lack of grasp. Recently, a Fed governor spoke of the minimal savings rate as a sign of optimism. The soaring trade deficit, on the other hand, is generally put into a positive light with the argument that the flood of imports of both foreign capital and foreign goods reflects America's dynamism.

The truth, rather, is that at 15% (measured as a share of GDP), U.S. import penetration of goods and services is unusually low in comparison to other major industrialized countries. For instance, it is 33% for Germany and 28% for the United Kingdom. In reality, what America grossly lacks compared to other major industrialized countries is competitive export capacity, and this, for sure, is primarily a problem of underinvestment in manufacturing.

BEWARE OF PROPERTY BUBBLES

Pondering the U.S. economy's prospects, the dramatic aggravation of the economic and financial imbalances is most critical. With them, there can never be normal economic growth. The other crucial aspect is the obvious fact that U.S. economic growth depends entirely on the continuation of the frenetic housing bubble.

All bubbles essentially end painfully, housing bubbles in particular. They are an especially dangerous sort of asset bubble, because of their extraordinary debt intensity. The debt numbers speak for themselves: In 1996, U.S. private households borrowed $332.2 billion; in 2000, their borrowing was up to $558.6 billion. With the housing bubble in full force, it hit $1,017.9 billion in 2004.

This debt intensity has its compelling reason in the particular way that accruing "wealth" has to be converted into cash. In the case of an equity bubble, in general, the owner realizes capital gains simply through selling a part of his stock holdings. No bank and no debt are involved. He directly exchanges stock for cash.

In this respect, a property bubble is a totally different animal. Since homeowners normally want to stay in their house, "wealth effects" have to be extracted through additional borrowing against the inflating property value; that is, through mortgage refinancing. In essence, twofold borrowing is needed: *first*, to boost housing prices; and *second*, to withdraw equity.

But this debt intensity finds very little or no attention at all. Yet there is a second, even more dangerous, aspect to housing bubbles: They heavily entangle banks and the whole financial system as lenders. For this reason, as a matter of fact, property bubbles have historically been the regular main cause of major financial crises.

During its bubble years in the late 1980s, Japan had rampant bubbles both in stocks and property. While the focus is always on the more spectacular equity bubble, hindsight leaves no doubt that the following economic disaster was mainly rooted in the property bubble. Both bubbles burst in the end, but the property deflation has continued for 13 years now, with calamitous effects on the banking system through a horrendous legacy of bad loans.

As a result, Japan has been struggling for years with two kinds of endless price deflation: gradually in the prices of goods and services and savagely in asset prices. The main culprit in keeping the economy locked in chronic stagnation is the evil concurrence of protracted property and debt deflation plainly strangling the banking system.

The third victim of a bursting property bubble is the building sector. Japan's has never recovered from the depression following its excesses in the late 1980s. After all, the property bubble of the late 1980s turned out to be the prescription for a 1930s-style debt deflation. In 2004, residential building contributed 0.51 percentage points to the reported U.S. real GDP growth, compared with 0.03 percentage points in 2000.

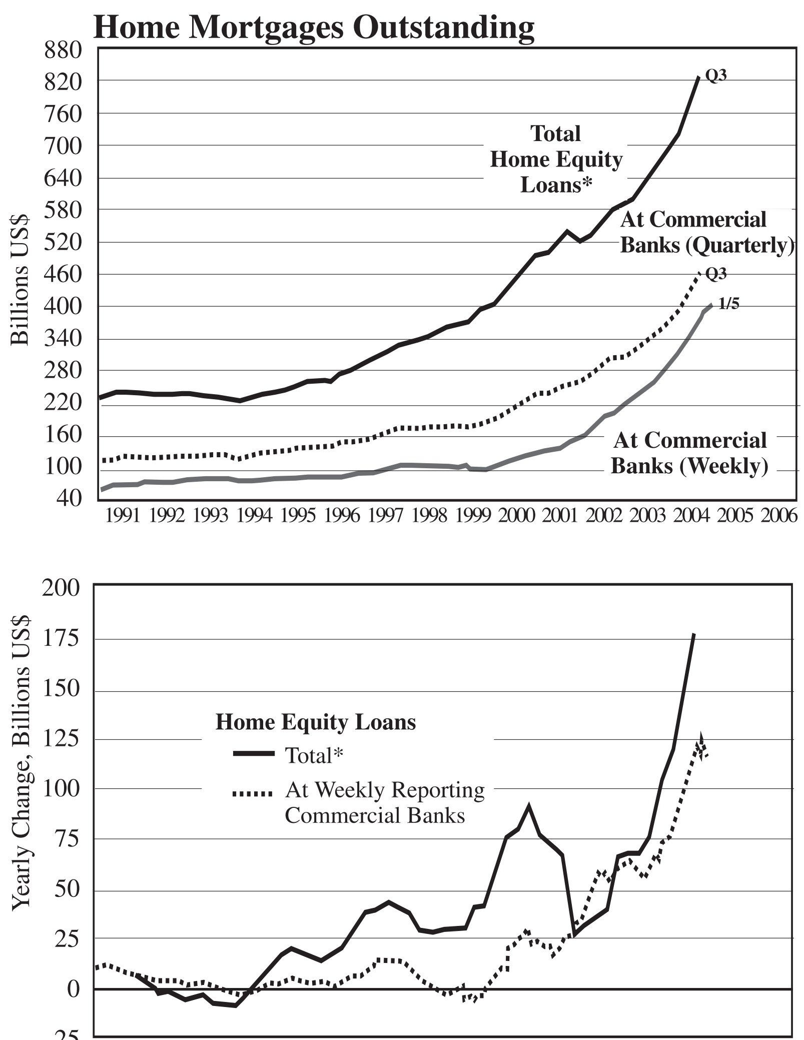
We have gone into these details about the dangerous nature of housing bubbles, and property bubbles in general, with one question uppermost in our mind: Is the U.S. economy in better or worse shape today than it was in 2000? Put differently: Is it in a self-sustaining recovery?

In short, it is in dramatically worse shape. Stating this, we have our eyes on the described escalation of the imbalances and, in addition, on the runaway debt growth in relation to income growth.

During the four years 2000–04, total indebtedness ballooned by $9.7 trillion, against a simultaneous increase in national income. For each dollar added to national income, there was almost $6.40 added to overall indebtedness.

Implicitly, the smallest part of this horrendous borrowing binge was spent inside the economy, as reflected in the poor growth of national income. Overwhelmingly, it financed leveraged asset purchases and soaring imports. The former involve no income creation; the latter involve income destruction.

By implication, this borrowing represents entirely unproductive, or dead-weight, debt, yielding to the debtors no future flow of income from which to pay their debt services. Business investment, the sole source of productive debt, was no higher in 2004 than in 2000.



***Loans made under home equity lines of credit and home equity loans secured by junior liens. Excludes home equity loans held by mortgage companies and individuals.**

Source: Yardeni.com

MR. PONZI SALUTES

For us, it is a compelling conclusion that this debt explosion overwhelmingly

mirrors Ponzi finance, meaning that debt service is paid with new debt. Assuming an average interest rate of 5% on outstanding debts of $36.2 trillion in the United States, current overall debt service is running at an annual rate of about $1.8 trillion.

Focusing on the consumer, we note the following financial development. In 1996, the start of the equity bubble, his disposable income rose by $280.3 billion. Simultaneously, he increased his spending on goods, services and new housing by $312.3 billion, and his borrowing by $332.2 billion.

In 2000, the equivalent figures were $499 billion for disposable income, $478.9 billion for total spending and $558.6 billion for total borrowing. For 2004: disposable income up $474.1 billion, total spending up $560.1 billion and borrowing up $1,017 billion.

In 2004, household debt increased more than twice as fast as disposable income. Debt production in the United States has run absurdly out of proportion to income production.

Earlier, we mentioned that it is mainly bad loans on real estate that have paralyzed Japan's banking system. America's commercial banks, not to mention its numerous subprime lenders, are doing their best to beat the follies of their Japanese brethren. Real estate lending by commercial banks has soared as a share of total lending in the past few years, lately accounting for 63% of total outstanding loans, as compared with 41% 10 years ago.

So is there a housing bubble? An infallible measure of a housing bubble is associated debt creation. In the United States, the increase in debt defies economic and financial reason — and imagination.

IT IS NOT WEALTH! IT IS INFLATION!

Asset and credit bubbles implicitly end in busts. Only a bust's timing is unforeseeable. In the United States, the lenders are desperately trying to prolong the bubble by laxer and laxer lending conditions.

In a rousing defense of the credit bubble, Mr. Greenspan — in his speech "The Mortgage Market and Consumer Debt," made on Oct. 19, 2004, before America's Community Bankers in Washington — flatly dismissed any debt perils with the argument that this borrowing was fine as long as it remained in reasonable alignment with rising property values.

That is, of course, the popular view in the United States. Still, it is a shame for the chairman of the Federal Reserve to say such a thing. A fact to consider is that credit bubbles drive asset bubbles with tremendous leverage, as the price of the last trade is mechanically translated into an equivalent change in the value of all existing houses.

Put bluntly, when the prices of a small percentage of existing houses are sold 5% higher in any given month than trades in the prior month, this lifts the value of perhaps 150 million existing houses in the United States by the same percentage. This is around 200 times leverage in wealth creation. In reality, it is dubious statistical arithmetic.

"Wealth creation" is the prevailing euphemistic American interpretation. According to reports, American households are amassing wealth in this way as never before, vastly outpacing their soaring debt growth. For us, it is scandalous that policymakers and economists can propagate this nonsense without a single voice of protest.

What about the wealth aspect? In principle, a rise of asset values can have three different causes:* first*, higher yields;* second*, higher available savings; and* third*, artificially low interest rates driving credit-financed purchases.

Of the three possible causes, the third is definitely decisive for the protracted rise in U.S. house prices. This unmistakably qualifies it as "house-price inflation," not as "wealth creation."

"WEALTH" THAT IMPOVERISHES

Do inflating house prices truly enrich homeowners? Do they enrich the nation? Our short answer to both questions is a categorical no. The ugly truth is that both are impoverished.

Let us start our long answer with a quote from Friedrich von Hayek: *"The means of perception employed in statistics are not the same as those employed in economic theory."* American economists think far too much in statistical terms, regardless of underlying economic processes. While the statistics do, indeed, show general enrichment, in reality, there is none at all. The homeowner has zero gain in his comfort of living or income.

This perception of wealth has its true basis in nothing but the famous "greater fool theory"; that is, in the expectation that there will be a greater fool to buy the acquired house later at a higher price. Deluded by this wealth chimera, private households have run down their savings and piled up astronomic debts to be repaid with future earned income.

Where, then, are the economic benefits? The one obvious visible benefit is in the push to GDP growth from higher consumer spending, which also increases current incomes. Yes, but much of that spending on cars, furniture and houses is borrowed from the future. That is, the borrowing pulls future spending into the present, but, of course, at the expense of such spending in the future.

If you think it over, you realize that in reality, such a borrowing/spending bubble adds nothing to economic growth. It only distorts the time pattern of spending in relation to its long-term trend, as in the case of the consumer determined by the underlying rate of income growth.

The second problem is that such a bubble distorts and deforms the direction of demand and production in the economy. Consider these grossly disproportionate increases in U.S. domestic spending since 2000: consumer durables +30.8%, residential building +29.5%, nonresidential investment +5.8%, imports +23.5%, exports +5.8%.

Strikingly, all economies with housing bubbles have features in common that were, in the past, generally associated with ailing economies. These are collapsed savings; skyrocketing debts; chronic, large trade deficits; and booming residential investment, but weak business investment.

This coincidence is not accidental. The common denominator of these countries is runaway consumer spending. That is the key point. The big spending excesses in these countries are in consumption, while business fixed investment is in the doldrums. Policymakers and economists in the countries with these symptoms are the first in history to proclaim that people and nations become richer with consumer borrowing-and-spending binges.

Consumption never creates wealth. It is categorical: Capital decreases when consumer spending exceeds production. What is happening in these countries is the exact opposite of wealth. It is capital consumption in the sense that consumption absorbs a growing share of GDP at the expense of investment and the trade balance.

On the macro level, this is impoverishment. As a matter of fact, it is statistically easily verifiable. It shows in the comparison of soaring U.S. foreign indebtedness to the lagging growth of the domestic capital stock, as measured by net capital investment.

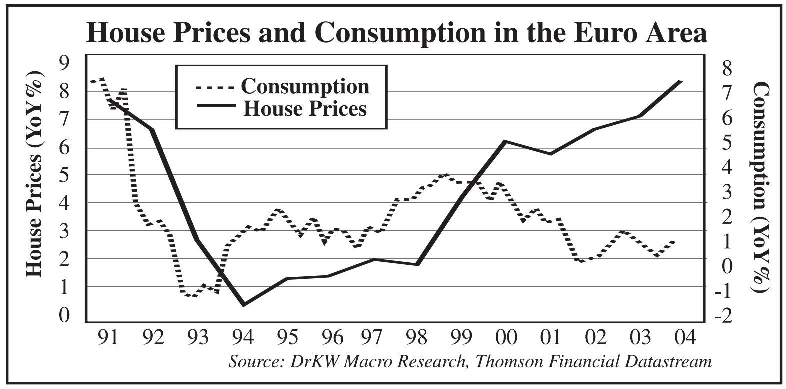
U.S. net foreign debts are increasing at an annual rate of around $700 billion, or 6% of GDP. The available data for America's net fixed investment end in 2003; in that year, net private domestic investment amounted to $529.9 billion, or 4.8% of GDP. Of this total, residential building accounted for 3.4% of GDP and nonresidential investment for 1.4%.

Traditional economic thinking assumes that higher consumer spending stimulates businesses to increase their spending on capital investment and employment. This went badly wrong. It has not been realized that excessive consumption, taking up a rising share of GDP, has the exact opposite effect of depressing savings, investment and the trade balance through well-known crowding-out processes.

If you think all this over, you will realize that the American economic reality on the macro level is not record wealth creation, but national impoverishment, foreboding a declining living standard. Take the borrowed import surplus away, and U.S. living standards collapse.

ASSET BUBBLES VERSUS BUBBLE ECONOMIES

Among the industrialized countries, Japan and Germany are the two great exceptions that have missed the global housing bubble. Japan is still struggling with the aftermath of its building bubble in the late 1980s, while Germany is struggling with the building bubble that developed in eastern Germany in the wake of unification.



Yet speaking of a global housing bubble, we hasten to emphasize again that there is one all-important difference in such bubbles. There are countries where rising house prices have been isolated events in the price system without significant effects on the economy, and there are countries where the housing bubbles have become the dominant influence both on the economies and financial systems.

This really is the dividing line between bubble economies and nonbubble economies.

The chart above clearly shows that the inflating house prices in Europe have even failed to prevent a slow decline of consumer spending. Consumers maintained their high saving rates.

Now one question: What does this aversion to consumer borrowing have to do with monetary and fiscal policies? What does it have to do with fundamental economic weakness? Absolutely nothing.

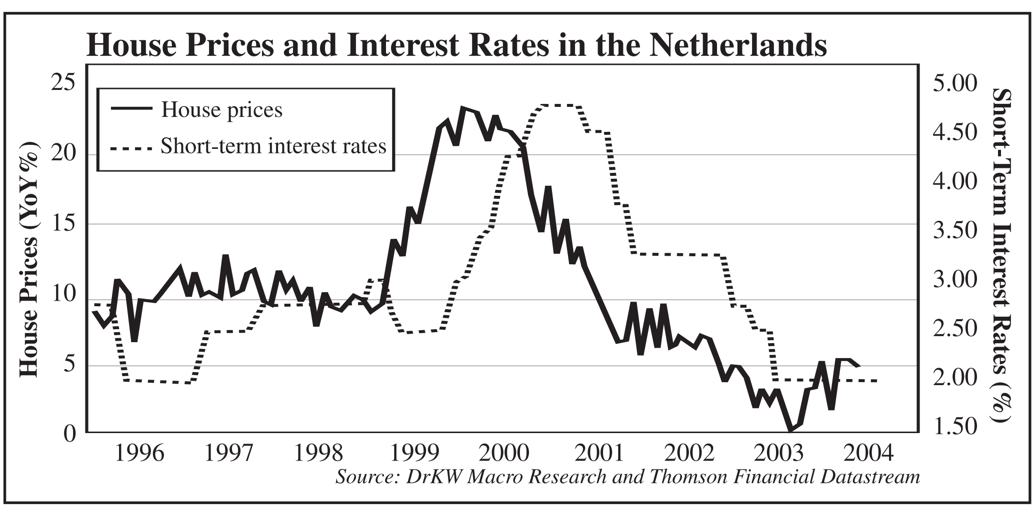
It has to do with a traditional cultural aversion in Europe to consumer borrowing for purposes other than building or buying a house.

And of course, it is stupid to believe that this aversion can be broken with still lower interest rates. In the first place, it robs the savers of income on their large mass of existing savings. It will shock them. The crucial difference to see is that Europeans are primarily savers, while people in Anglo-Saxon countries are primarily borrowers.

Consumption-driven bubble economies reveal themselves at first through sharply falling personal savings. Their second typical, yet spectacular, hallmark is large trade deficits.

A WARNING EXAMPLE

In the end, the main question is, of course, what happens when a housing bubble expires. As to be expected, Mr. Greenspan and the bullish consensus deny the possibility of a hard landing. A little logic says that such a landing is inevitable.



An illuminating case in this respect is the very recent experience in the Netherlands. While traditionally a country highly conservative in its finances, it developed a housing bubble in 1998–99, after years of strong economic

growth. House prices and credit growth soared at double-digit rates. As homeowners cashing in on their burgeoning home equity went on a spending spree, the household savings rate plunged from 12.9% of disposable income in 1998 to 6.8% just two years later.

The chart on the prior page highlights what happened. As the Dutch central bank raised its short-term rate from 2.5% to 4.5% from 1999–2000, house price inflation came to an abrupt halt. Household borrowing and mortgage equity withdrawal slumped sharply.

Being deprived of their "wealth effects," the Dutch people returned to saving from their current income. Within just three years, the personal savings ratio was back to 12%, driving the Dutch economy into the worst recession among the industrialized countries. The growth rate of consumer spending sagged in a straight line from 4.7% in 1999 to minus 1.2% in 2003.

We have recalled this episode to emphasize one point of greatest importance, yet one that is widely ignored. The Dutch example confirms that for consumer spending to slump in the wake of a fading housing bubble, house prices do not need to fall at all. It is sufficient that they stop rising, thereby depriving households of new wealth effects and the associated borrowing facilities.

Therefore, major housing bubbles imperatively end in a hard landing. A second major adverse influence on economic growth implicitly arises from the sudden cessation of the building boom. Yet the worst looming problem is always the potential damage to the banking system through escalating bad loans.

On Dec. 5, 1996, when Alan Greenspan made his famous remark about possible *"irrational exuberance"* in the stock market, he asked a rhetorical question: *"How do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions, as they have in Japan over the past decade?"*

For a central banker, that is really a most astonishing question. With some knowledge in macroeconomics, bubble economies — in the sense that asset bubbles impact the economy — are most easily identifiable. The simple clue is in the relationship between soaring credit and collapsing savings.

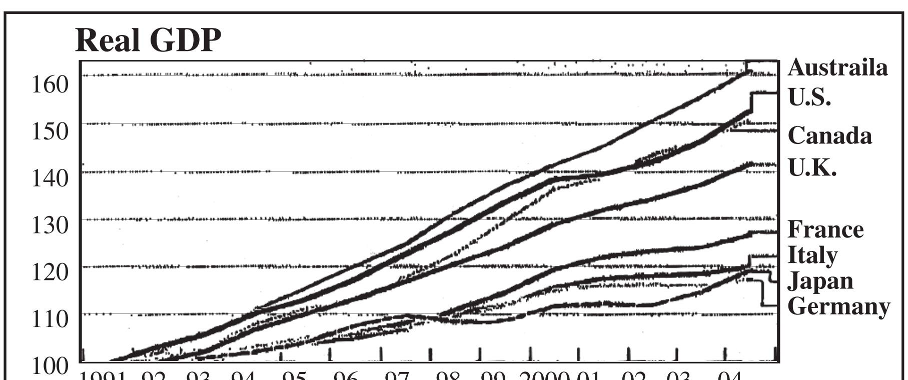
Consider that last year, the United States had recorded an overall credit expansion of $2,718.6 billion, versus virtually zero national saving.

"WHY ARE ENGLISH-SPEAKING NATIONS DOING BEST?"

The subhead above is the title of an article by Martin Wolf in the *Financial Times* on Jan. 12, 2005. It starts as follows:

"In 1992, when Bill Clinton was elected president of the United States, he promised to learn from Germany. Rightly or wrongly, any American president who did so today would be regarded as mad. Germany is now viewed as the sick man of Europe.

"This illustrates a fascinating reversal. The long decades of post-Second World War decline of the English-speaking, high-income countries have ended. Since the early 1990s, they have been doing better than many other long-established high-income countries, and above all, than the four dominant non-English-speaking countries: Japan, Germany, France and Italy."



Source: IMF, OECD, Thomson Financial Datastream

Mr. Wolf touched upon a most interesting and most important question, raising three other huge questions. *First*, why has the

performance of the non-English-speaking countries deteriorated so much? *Second*, why has the performance of the English-speaking countries improved so much, at least relative to the nadir in the 1970s? And *third*, will the relative outperformance of the latter last?

In both groups, there are, of course, many different influences at work. But looking for the key causes, we focus on two aggregates — savings and investment. To quote John Maynard Keynes in analyzing the Depression of the 1930s: *"The whole matter may be summed up by saying that a boom is generated when investment exceeds saving, and a slump is generated when saving exceeds investment… It is out of the disequilibriums of savings and investment, and out of nothing else, that the fluctuations of profits, of output and of employment are generated."*

This simple formula contains the main explanation for the striking difference in the recent economic performance between the English-speaking countries and the four major non-English-speaking countries.

As to saving and investment, the economies of the two groups of countries are of radically different natures. The non-English-speaking countries traditionally have high rates of saving and investment. The opposite traditionally is true of the English-speaking countries.

The recent common feature of both groups, and, actually, of all industrialized countries, has been a slump in business fixed investment. For the high-investment economies, it meant, first of all, a generally sharper fall.

Obviously, the most important cause for the difference in economic performance, however, is that France, Germany and Italy remain stuck with their traditional high household saving ratios of between 10–11% of disposable income. Japan has sharply lower savings but, with its post-bubble troubles, should be considered a special case.

Why, then, have the English-speaking countries performed so much better? In short: because they have dramatically improved their savings-investment balance in favor of investment. Remember Keynes: *"A boom is generated when investment exceeds savings."*

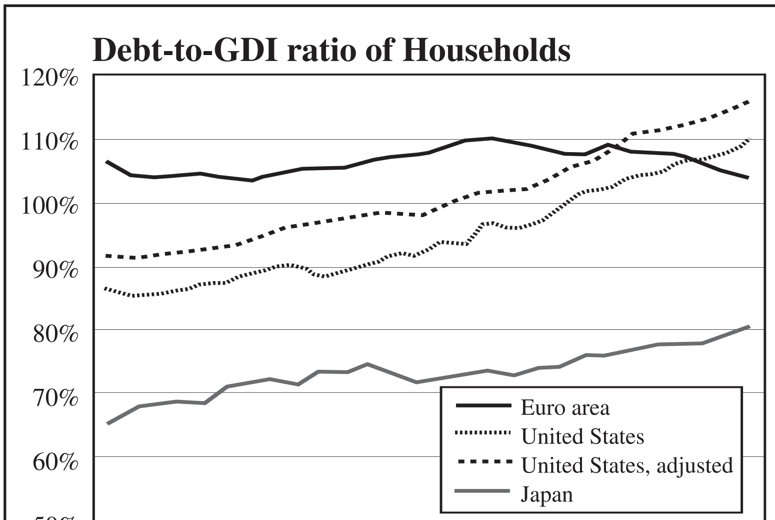
But the irony of this adjustment is that it results entirely from the fact that with their housing bubbles they have slashed their savings even faster than their investments. In short, the English-speaking countries have managed to diminish their savings faster than the decline of their investments. We would not regard this as a positive pattern of restructuring.

IS THIS A VIRTUE?

This brings us to Mr. Wolf's third "big" question: Will the relative outperformance of the English-speaking group last? It is, for sure, the crucial question for the whole world, since the spending binges of their consumers have been providing strong support to economic growth in the rest of the world.

There appears to be a general expectation that the "high-growth" economies of the past few years — in other words, the English-speaking countries — will continue to outperform the famous laggards in Europe and Japan. There is a widespread view that their stronger economic growth is a mark of success. We disagree.

Such quandaries always remind us of a remark by Ludwig von Mises: *"It may sometimes be expedient for a man to heat the stove with his furniture. But if he does,*



Sources: ECB, Federal Reserve, U.S. Bureau of Economic Analysis, Bank of Japan, Japanese Economic and Social Research Institute and ECB Calculations

he should know what the remoter effects will be. He should not delude himself by believing that he has discovered a wonderful new method of heating his premises."

Are housing bubbles a wonderful new method of promoting economic growth and prosperity?

Clearly, they boost GDP growth in the short run. But this growth pattern, bought with skyrocketing indebtedness, is full of structural maladjustments impairing economic growth in the long run.

Our basic assumption is that the recovery in the industrialized countries from the 2001 recession has peaked and that a protracted slowdown lies ahead. It was a poor recovery for all countries, the United States included. Lately, evidence of spreading economic weakness is mounting on both sides of the Atlantic.

NO RECOVERY FOR THE PEOPLE

Stating this, we feel urged to make some remarks about Europe's economic performance relative to that of the U.S. economy. According to conventional global wisdom, Europe's economy is permanently underperforming the U.S. economy owing to "structural rigidities." The usual measures of Europe's widely alleged economic backwardness are the considerably higher rates of U.S. GDP and productivity growth.

Focusing on the recovery years since 2001, we see two main reasons for the U.S. economy's superior growth performance, as reported. One is diametrically different monetary and fiscal policies, and the other is significant differences in the statistics concerning GDP and productivity growth. U.S. real GDP is up 9.6% over these three years. That of the eurozone is up 3.5%.

This, for sure, makes a shocking difference, provided the underlying inflation rates are precisely comparable. But they are not. As we have reported many times, the statisticians of the Bureau of Labor Statistics have systematically labored to lower the U.S. inflation rates, above all by translating quality improvements into price reductions — so much so that it led to cries of deflation in 2003.

Semiofficial American sources put the downward effect of these statistical adjustments on consumer prices at 1.5% annually. This would virtually wipe out the recorded growth difference between Europe and the United States, as measured by real GDP.

Admittedly, this seems an absurd idea. Therefore, we decided to check it on the income side. In principle, GDP growth and income growth should be equal, because any spending creates corresponding income. We discovered an unbelievably huge discrepancy. Over the four years 2000–04, U.S. GDP has increased by 10.4% in real terms and 19.5% in nominal terms.

On the income side of the equation, total personal incomes are up 14.7%, and wage and salary disbursements are up 10.9% overall and 9.3% in the private sector — all numbers in nominal terms. The fact is that the increase in the income flow from the private sector has barely covered the rise of the understated inflation rate over these four years. For America's 147 million employees, the economy's recovery has been chimerical in the aggregate. In order to maintain their living standards, they had to borrow.

FALSE GLOOM, FALSE OPTIMISM

What next? That is the new great question. For the time being, the news about the euro area conveys nothing but gloom. Nobody seems to worry about the Anglo-Saxon bubble economies. We do.

Plainly, the latter are vulnerable to a sudden, sharp reversal in their bubble-driven consumer spending. All that is needed for that to happen is abating house price inflation, as is already unfolding in England and Australia. To maintain their economic growth, these countries would need an investment boom, which is nowhere in sight.

Our modest relative optimism about the euro area has its main reason in the absence of serious bubble excesses. With their very high savings rates, these economies are definitely not vulnerable to sharp economic downturns.

In our view, the cultivated gloom about the euro area is grossly exaggerated. It is the curse of the eurozone that with so many countries there are so many more country surveys to look at than in other economic regions. Besides, we see a most important difference between survey results in the United States and Europe. Americans (including Mr. Greenspan) are notoriously uncritical; Europeans are notoriously critical.

The euro area's central problem, as explained, is the persistently high rates of personal saving. In 2004, a mere 56.9% of GDP growth came from personal consumption, as against 71% in the United States. Gross fixed capital formation accounted for 19.9% and foreign trade for 2.1% of GDP growth. This is a very healthy growth pattern. The weakness in consumption is in essence a mentality problem, not a policy problem.

As to "structural rigidities," we see far more of them in the United States than in Europe. Actually, the manufacturing sectors have responded to this weakness in consumer spending with drives into exports, with Germany as the great export star. Despite the euro's sharp ascent, Germany's annual trade surplus has soared from €115.6 billion to €156.7 billion since 2000. For the area as a whole, the trade surplus amounted to €103.4 billion in 2004, as against a large deficit in 2000.

WHO NEEDS DRASTIC RESTRUCTURING?

Despite all the fanfare over new jobs, the decisive missing link in this U.S. recovery is the lack of organic income creation through wages and salaries. But why is that? In short, it reflects a protracted structural distortion. The big employment gains have been in low-paying, temp-dominated service jobs — in administrative and waste services, health care, social assistance and restaurants — while the big job losses have been in high-paying manufacturing.

As we have repeatedly emphasized, America's key economic problem is the accelerating demise of its manufacturing sector. More health service is no substitute for less manufacturing. Amazingly, policymakers and most economists completely fail to see the direct causal connection with the escalating trade deficit.

BusinessWeek recently carried an article that states, *"The economy's elusive 'soft spot,' which has commanded so much attention in recent weeks, is coming into clearer focus. It's called manufacturing. U.S. factory output and payrolls seem to be taking the biggest hit from this year's energy-related slowdown in domestic and global demand."*

This is ridiculous. The U.S. manufacturing sector's demise started in the 1980s. But it has sharply accelerated in the past few years — plainly taking its hit over all these years from the exploding trade deficit, up from $135.9 billion in 1997 to $413.4 billion in 2000 and, more recently, to more than $700 billion, at annual rate. Each dollar added to the U.S. trade deficit is a dollar lost to U.S. manufacturing.

This recognition immediately raises the next concern: the cause or causes of the U.S. trade deficit. Any protracted major trade deficit implicitly reflects an excess of domestic spending over output.

It is convenient and conventional wisdom in the United States that trade deficits primarily reflect differences in economic growth. This has never been true. What makes trade deficits and trade surpluses is not a country's rate of growth. It is the pattern of growth. The common structural features of deficit countries in the past and the present were always, and still are, consumer borrowing-and-spending binges with low domestic savings and investments. Most often, they also have government deficits.

Countries with investment-led economic growth, like Germany and Japan, never have trade deficits, not even in boom times, because supply is always ahead of domestic demand growth. The implicit coincidental feature is high savings. See China today.

In short, trade deficits are never an emblem of strong economic growth. They are always an emblem of credit excess financing consumption excess. In fact, this is the common key feature of English-speaking countries.

In the case of the United States, the debt-driven consumption excess is definitely the primary evil. However, a second powerful force has come into play. That is China's investment boom propelling exports to the United States.

This brings us to the greatest irony of all in this development. The crucial originator of the Chinese investment and export boom is the United States itself. It has done so in two ways: primarily through the strong import pull of its domestic demand excess, but secondarily through the powerful effect of the dollar surpluses on China's banks. Acting as high-powered central bank money for the Chinese financial system, dollars have been fueling a runaway credit expansion — overwhelmingly financing building and industrial capacity seeking an outlet in the United States.

CONCLUSIONS

The overriding consideration for the present situation and the further economic outlook for the industrialized countries has to be the recognition that the recovery from the 2001 recession has generally peaked. How much weakness is now in store? That is the new great question.

There are two different ways to assess economic prospects. The one is through asking others (surveys); the other one is through analysis of the objective facts.

Our way is the latter. In our view, the extraordinary extent of the borrowing-and-spending excesses in connection with the housing bubbles in the Anglo-Saxon economies suggests an unavoidable hard landing for them, of both the economies and their asset markets.

What these countries experienced was not fundamental strength. It was temporary bubble strength. Conversely, we would not speak of fundamental weakness in the case of the eurozone economy, where the slow growth results from stubbornly high savings rates.

Just as inconceivable appears to be a sharp slowdown of the Chinese economy. Most data continue to show a booming economy, in particular in production and exports. However, there has been a stunning slump in import growth over the past few months, associated with a stunning reversal of the boom in industrial commodity prices. Movements in imports are generally the earliest gauge of a change in domestic demand.

Downbeat investor sentiment surveys suggest that concern about economic and profit growth has soared. Above all the continuous decline of bond yields raises the question of whether the markets are beginning to anticipate not merely a "soft patch."

To repeat: The economic and financial situation in the United States is today far worse than in 2000, when the economy's slowdown began. What's worse, monetary and fiscal policy have no ammunition left.

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